00-0476

IAWC Exhibit 9.0SR

BEFORE THE ILLINOIS COMMERCE COMMISSION

Surrebuttal Testimony

Of

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On Behalf of

Illinois-American Water Company

CH: 1144060

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I. INTRODUCTION

Q: State your name and business address.

A: My name is Thomas J. Flaherty. My business address is 6363 N. State Hwy. 161, Suite 800, Irving, Texas 75038.

Q: Are you the same Thomas J. Flaherty who filed rebuttal testimony in this proceeding?

A: Yes.

II. PURPOSE OF TESTIMONY

Q: What is the purpose of your surrebuttal testimony?

A: The purpose of my surrebuttal testimony is to respond to issues raised by witnesses Thomas Q. Smith, David Borden, and Mary Everson on behalf of the Illinois Commerce Commission Staff ("Staff"). I will also address the comments of witness Michael Gorman on behalf of the Illinois Industrial Water Consumers ("IIWC"). Specifically, I will address their comments regarding the Savings Sharing Proposal, its workability, validity, auditability and impact on customers.

III. SUMMARY OF TESTIMONY

Q: Please summarize your Surrebuttal to the Rebuttal Testimony of Staff and IIWC.

A: The Staff and IIWC witnesses' arguments against the Savings Sharing Proposal are fundamentally incorrect and the product of narrow application of regulatory policies and principles. If these narrow views are adopted, customers will have to forego the benefits that arise from the Acquisition. This would not be effective public policy. Illinois-American Water Company ("IAWC" or "the Company") has proposed a Savings Sharing Proposal which allocates Acquisition related savings between shareholders and customers. This proposal provides the customers the ability to share in those savings without being at risk for the achievement of those savings, while providing shareholders a chance to recover the Acquisition Premium. The Savings Sharing Proposal proposes an amortization of the Acquisition Premium over a 40-year period, which results in regular measurement of the savings achieved across this period within the Company's expected or standard rate case proceedings. My Surrebuttal Testimony will demonstrate that, contrary to the assertions in the Rebuttal Testimony of the Staff and Mr. Gorman, IAWC's Savings Sharing Proposal is a workable proposal that meets the needs of all constituencies.

Savings sharing plans have been used repeatedly by commissions in recent years to equitably allocate merger and acquisition related savings between customers and shareholders. These plans, and other allocation mechanisms, have been deemed necessary and beneficial to the public interest as the utility industry consolidates. Savings sharing, without direct responsibility for acquisition cost recovery, is a normal mechanism that allows the customers to receive the benefits of consolidation without being at risk for the achievement of savings.

Staff's and Mr. Gorman's Direct and Rebuttal Testimony argue that the Savings Sharing Proposal offered by the Company is unworkable because the proposal covers a long period of time, the amount of savings cannot be proven or are not auditable, and that the estimated savings are not achievable. These arguments are not valid. Savings sharing plans have been used successfully to allocate savings between customers and shareholders, and have shown that savings estimated by the combining companies are regularly realized and sometimes exceeded. The proposal offered by IAWC will provide both workable mechanisms and documentation to identify, track and validate the savings across both short and long-term periods.

IV. OVERVIEW OF STAFF'S AND IIWC REBUTTAL TESTIMONY

Q: Please summarize the portions of the Rebuttal Testimony of Staff and IIWC witnesses that you will address.

A: The portions of the Staff and IIWC Rebuttal Testimony I am addressing are the arguments surrounding the workability and achievability of the proposal. Specifically, these issues include:

- That recovery of an Acquisition Premium is not justified in this case.
- That customers are at risk of recovery of the Acquisition Premium.
- That it is difficult, if not impossible, to define and track cost savings.
- That the 40-year period is too long and unmanageable.

While there are a variety of arguments presented by these witnesses, the listing above reflects the primary issues the Staff and Mr. Gorman raise in objection to the Savings Sharing Proposal put forth by IAWC. Most of these arguments against the Savings Sharing Proposal reflect erroneous assumptions about the design and mechanics of the plan, and are based on a misplaced sense of uncertainty and complexity that is not justified.

V. ACQUISITION PREMIUM RECOGNITION

Q: What are the objections raised regarding the inclusion of the Acquisition Premium in the rate base?

A: Witness Borden is opposed to the inclusion of an Acquisition Premium in light of the fact that Citizens Utilities Company of Illinois ("Citizens" or "CUCI") is not facing "impending financial failure".

Q: Is financial failure the only reason a commission should approve the inclusion of acquisition premiums in the rate base?

A: No, this would not send the correct signals to any of the principal stakeholders, particularly the marketplace. The policy followed by the Illinois Commerce Commission (ICC) should seek to incentivize combinations which promote savings and long term cost effective service, rather than merely address situations of financial failure through reorganizations. The inclusion of acquisition premiums into the rate base of a utility is done to encourage investment, for numerous reasons. These reasons may include operating expertise, improved capital structure, economies of scale, or better service. In the case of IAWC, the acquisition will leave the combined company financially stronger and better able to continue providing safe, reliable service at lower costs than if the Acquisition does not take place.

The creation of savings through combination is what justifies, to the extent the savings are realized, recovery of the Acquisition Premium. IAWC's Savings Sharing Proposal is structured to assure that, in the worst possible case, there would be "no net cost" to the customer. In reality, the Company anticipates significant cost reductions will be realized by the Acquisition and equitably allocated between the shareholders and customers pursuant to the proposed Savings Sharing Proposal. The issue should not be whether IAWC or CUCI is in financial jeopardy. If customers benefit from the transaction, there is an implicit responsibility to not benefit at the expense of shareholders. Thus, shareholders should not be penalized for their willingness to fund the amounts necessary to realize such benefits and should have a higher expectation than "impending financial failure" for recovery of their investment.

Q: **Witness Borden contends that recovery of an acquisition premium is inappropriate in this instance since Citizens and IAWC are regulated monopolies. Is this valid?**

A: No. It is only logical, from the customers' perspective, to allow the recovery of acquisition premiums to the extent the savings resulting from the transaction equal or exceed the amortization of that premium. In such situations, the customers incur "no net loss" as a result of the transaction. It is true that if an acquisition can bring benefits, in the form of savings and/or improved service, customers will be better off. If the recovery of an acquisition premium is required, as in this case, to incent investors to make the investment necessary to bring about those improvements, then it only makes sense to allow that recovery. This point has been addressed and reinforced by numerous commissions across the country. Mr. Borden is wrong in his insinuation that such policies lead to ever increasing rates for ratepayers. The "no net cost" test insures that acquisition premium amortization can not lead to higher rates, since, by definition, no acquisition which meets this test leads to higher rates.

VI. CUSTOMERS' RISK LEVEL

Q: Do you agree with witnesses Smith, Borden and Gorman that under the Company's proposal, customers are at risk for higher costs than if no transaction took place?

A: No. These witnesses have each presented differing reasons why the customers may be at risk under this proposal; however each is incorrect in their assumptions. Mr. Smith assumes that the customers will be required to fund any shortfalls between estimated savings and realized savings, which is incorrect. Mr. Borden asserts that another unidentified acquirer could offer even greater savings or a more generous allocation of savings to the customers in the future, which is wholly speculative. Finally, Mr. Gorman asserts that failure of the Company to achieve savings will lead to financial impairments that may ultimately lead to an increased cost of capital.

Q: Please comment on Mr. Smith's assertion that customers may be required to bear higher costs.

A: Mr. Smith has incorrectly characterized the nature of the proposal offered by IAWC in his Schedule 1. In his analysis, Mr. Smith uses the cost structure of the utility assuming the transaction takes place, but does not compare the new costs to the baseline costs or what the costs would have been absent the transaction. Without comparing the post transaction costs to those costs that would have been incurred absent the transaction, no analysis of savings can take place. This can be corrected by adding the full amount of the savings in each scenario to achieve the baseline costs, then applying the savings sharing ratios per the proposal. Doing so creates the following results:

		Scenario 1 As presented	Scenario 1 Corrected	Scenario 2 As Presented	Scenario 2 Corrected	Scenario 3 As Presented	Scenario 3 Corrected
1	Total Cost of Svc	100,000,000	100,000,000	100,000,000	100,000,000	100,000,000	100,000,000
1a	CUCI/IAWC Stand-alone Cost of Svc	-	105,500,000		108,400,000		100,000,000
2	Acq Rev Req (ARR)	6,800,000	6,800,000	6,800,000	6,800,000	6,800,000	6,800,000
3	Acquisition Savings	5,500,000	5,500,000	8,400,000	8,400,000	0	0
4	10% to Customers	550,000	550,000	840,000	840,000	0	0
5	Offset to ARR	4,950,000	4,950,000	7,560,000	7,560,000	0	0
6	50% Split w/Cust	0	0	380,000	380,000	0	0
7	Total Rev Req	104,950,000	104,950,000	107,180,000	107,180,000	100,000,000	100,000,000
8	Savings to Customers	(4,950,000)	550,000	(7,180,000)	1,220,000	0	0

Q: Would you please explain how these calculations were made?

A: Yes. The table contains two sets of columns for each of Mr. Smith's scenarios. The first shows how Mr. Smith represented the Savings Sharing Proposal, and the second is an accurate representation of the proposal calculated by myself. In Mr. Smith's numbers, the cost of service row reflects the combined entity's cost of service, he then adds the lesser of the realized savings or the acquisition revenue requirement, per the Savings Sharing Proposal. He also properly accounts for the 10% and 50% allocation of savings to customers when appropriate. His mistaken representation occurs on lines 7 and 8 where he compares the revenue requirement to the new cost of service and indicates a loss to customers. His analysis failed to include row 1a, the CUCI/ IAWC stand-alone cost of service, which I included in the corrected columns. When doing a proper comparison of the net cost to consumers in the combined entity to the Citizens stand-alone cost, the results are always non-negative numbers.

Had Mr. Smith properly represented the Savings Sharing Proposal in his analysis, he would have arrived at the conclusion that in no foreseeable event would customers be required to pay more than if the transaction had not occurred.

Q: Would you comment on Mr. Borden's speculation that another potential buyer may eventually purchase Citizens and offer greater savings than IAWC?

A: Yes. This comment is without merit and should be given no weight whatsoever. No alternative proposal has been properly presented for review by the Commission. Furthermore, the parent of IAWC, American Water Works Company, Inc., is the largest investor owned water company in the United States. It is unlikely that an alternate purchaser would be capable of bringing greater economies of scale to Citizens. Further, it is also specious to expect that another purchaser would be willing to make such an acquisition without a presumption that a reasonable savings sharing mechanism would be implemented in order to recover the acquisition premium required to make such a purchase.

Q: Mr. Smith indicates, at page 13, that we cannot know if the Savings Sharing Proposal is reasonable until we apply actual facts. Would you comment on this point?

A: Yes. For the reasons given by the Company witnesses, I believe that the Savings Sharing Proposal is reasonable and workable. Even though the actual facts have not yet been applied, it is possible to know at this time whether the proposal is reasonable or not. Although the actual level of future savings is not yet known, it is possible to determine, at this time, that a reasonable approach to measurement of savings has been developed and, therefore, that the Savings Sharing Proposal is reasonable.

The Savings Sharing Proposal requires the actual demonstration of savings, not in this proceeding, but in the future. Based upon the actual results of consolidation, Mr. Smith's testimony demonstrates that his issues with the nature of the proposal are premature and not grounded in fact, only his sense of uncertainty or lack of familiarity with similar proceedings. In other cases where approval for mergers or acquisitions has been provided, the actual level of savings was likewise not known. The Company must demonstrate that the savings are achievable and that customers will not be at undue risk for achieving those savings, both of which are accomplished through the Savings Sharing Proposal.

Q: Is it true that customers are at risk for higher costs under the Saving Sharing Proposal, since the Company would face higher capital costs if the Acquisition Premium were not recovered through savings?

A: No. If the Company were to complete the Acquisition without the potential for recovering the Acquisition Premium, the Company's financial performance would suffer. The Company, however, has indicated and would stipulate that in the event its Savings Sharing Proposal is approved, it will not seek to recover any increased capital costs associated with the inability to Demonstrate Savings. It is again speculative for the Staff to assert that a result may occur, without any supporting data other than supposition.

VII. SAVINGS SHARING PROPOSAL FEASIBILITY

Q: The Staff and Mr. Gorman question the workability of the proposed Savings Sharing Proposal. Can you explain what their primary concerns are?

A: Yes. Staff and Mr. Gorman focus their criticism of the proposal primarily on three issues. These issues are:

- That the savings events will not continue over the 40-year period.
- That there is no accounting method for tracking the savings.
- That the ability to estimate stand-alone costs for CUCI in future periods is too difficult.

These issues are "red herrings" used to disguise their goal of extracting 100% of the savings for the customers, in violation of the principle of an equitable sharing of benefits of the Acquisition. Although the Savings Sharing Proposal is not a traditional ratemaking mechanism used in the context of historical rate cases, it still is applicable to the issues at hand in this proceeding. Each of the above issues is addressed through the remainder of my testimony.

Q: Please comment on Mr. Smith's assertion that the Company has not adequately explained why it is appropriate to charge customers rates that reflect "non-existent" operating costs.

A: To begin with, the term "non-existent operating costs" is not accurate. Simply stated, the Company has proposed a regulatory plan which incorporates a Savings Sharing Proposal to accomplish the same objectives as achieved by other companies involved in similar transactions before other regulatory commissions. It is appropriate in this instance to utilize such a plan, because IAWC is making a substantial investment to acquire the water assets of Citizens. This acquisition can bring savings and service improvements over the short and long terms because IAWC is part of a large corporation that operates water systems across the country. Savings will be realized, because of the expertise and economies of scale attendant with the scale and scope of a large national company. Lacking this investment, these benefits cannot be brought to the Citizens customers. Without the opportunity to recover its costs and return on investment, IAWC would not have the incentive to make these investments. Therefore, IAWC has proposed a mechanism that enables recognition of benefits whereby customers can participate in the savings at no risk, while IAWC can recover its investment which brought about the Savings.

Secondly, the Company is not "charging" customers for these reduced costs, it is merely using increased cash flows to recover the Acquisition Revenue Requirement. As stated throughout this and others' testimony, customers benefit from reduced costs; they are not required to pay increased, phantom or illegitimate costs. To the extent that the savings events create savings beyond the level necessary to recover acquisition costs, then it is appropriate for customers to share some of these benefits with the party that made the benefits possible (as occurs under the Savings Sharing Proposal).

Mr. Smith simply refuses to differentiate these transactions from the more traditional rate case approaches with which he is familiar. In doing so, he is willing to force the customers to forego the available savings and other benefits from this transaction. Strict adherence to the status quo is shortsighted and could preclude any potential efficiencies and improvements for the ratepayers in the Citizens territories.

Q: Does the absence of accounting literature on cost savings mean that savings should not be considered within ratemaking proceedings?

A. No. As stated previously, Mr. Smith is looking to accounting manuals to find definitions and procedures for the accounting of savings. He will not find them there, nor should he expect to, because savings are not costs. Savings are the reduction of costs and are a critical element in economic decision-making. He can find ample evidence of savings treatment in the other savings sharing cases described in my Rebuttal Testimony and data request responses. Mr. Smith is searching for the wrong guidance in this respect. It is policy, not proscription, that should guide the ICC in this proceeding.

Q: Mr. Smith also suggests, at page 14, that the terms "cost savings" or "negative cost" have no accounting or ratemaking meaning. Would you comment on this point?

A: There is no substance to this point, as accounting definitions do not drive regulatory policy. As discussed elsewhere in Rebuttal Testimony, various data requests and in this Surrebuttal, commissions have been addressing and approving savings sharing plans in merger and acquisition cases for many years. In these cases, the term "cost savings" has been used repeatedly and consistently to describe the reduction in costs afforded by the acquisition or merger of two or more companies. IAWC has used this same definition of savings in this case. The term is not "misleading" as Mr. Smith asserts; rather, he himself accurately describes the definition of the term, as used here. Savings are a reduction to total cost, just as accumulated depreciation is a net against gross plant. The end result is the same, the amounts captured in an account or category are net and verifiable. Since many commissions have successfully dealt with net costs, it would appear that savings certainly has a regulatory meaning.

Q: Mr. Smith suggests that you believe that the Savings Sharing Proposal is complicated. Do you agree?

A: No. I have no understanding of how Mr. Smith reaches this conclusion. In my Rebuttal Testimony, I refer to the fact that identification of savings events is a simple process. This process is discussed in Mr. Stafford's Rebuttal Testimony and Surrebuttal Testimony. Further, once savings events occur, the resulting savings are easy to account for and reflect in future periods. Most transactions that accountants capture occur in a continuous stream of discreet events. The Acquisition Savings will be a finite set of events that, once captured, can be carried forward from period to period in simple fashion. I believe this process is straightforward and can be implemented without complexity.

Q: Is there any validity to Mr. Smith's comments, at page 18, that, "[n]o assumption could represent actual cost, or serve as a basis for identifying actual savings resulting from a merger."?

A: No. There certainly will be actual costs to review, as well as, actual savings impacts. Mr. Smith seems to misunderstand the difference between the actual savings, which will be known and determined at the time of the savings event, and the projection of those savings into future periods. While it is true that the use of some assumptions is necessary to extend the stand-alone costs, and therefore the net cost savings forward, these assumptions will be reviewed periodically by the ICC to ensure that the assumptions remain valid. That review can be conducted with the benefit of actual information concerning cost levels, technology, and other exogenous factors which have occurred since the last ICC review. Once a savings event has been identified, the assumption to be principally reviewed is that of the escalation rate. This is easily accomplished using available data regarding Company cost levels and publicly available information.

Q. Is forecasting stand-alone cost difficult or unreasonable in a ratemaking environment, as witnesses Smith, Borden and Everson suggest?

A. No. These witnesses suggest that since Citizens would no longer exist as a stand-alone entity; therefore, it would be impossible to estimate what its costs would be. As stated earlier, the cost assumptions of Citizens as a stand-alone company subsequent to the Acquisition can be reliably quantified through the use of traditional forecasting techniques. These types of forecasts are not new in ratemaking, and continue to be utilized. Commissions often use forecasting, trending, and other techniques to make reasonable estimates of future costs. The net salvage value calculation used in setting depreciation rates is one example. There are reliable predictors of future costs which may and can be implemented.

Q: Is it impossible to show savings in future periods, since Citizen's underlying cost structure cannot be known for certain throughout the 40-year period?

A. No. The Company has proposed that the actual savings will be specifically determined in future rate proceedings. This can be done by using the data underlying the current cost structure for the stand-alone ownership structure of Citizens as a baseline for future comparison. Actual costs will be verifiable in each of these future periods through traditional methods. The baseline costs can be determined by using the current stand-alone cost structure and the difference will generally be the result of the savings "events" that arise from the acquisition, and can be identified and evaluated individually. Verification of these figures can occur during the normal course of each ratemaking process. Continued use of savings sharing plans by a variety of ratemaking authorities broadly indicates that such plans are workable over short and long-term time frames and are not beyond the capacity of all parties to deal with.

It is also misleading to assert that the 40-year time frame creates an insurmountable obstacle to measurement. In reality, the measurement period is between each rate case with only those changes occurring between these dates being relevant. Once the baseline is established and the savings event occurs, it is *primarily escalation that creates the difference.* Review of the potential effects of exogenous factors also is necessary at each rate case. However, a belief that a water utility would look fundamentally different in future years is not realistic nor is it sound as a basis for regulatory policy.

Q: Do you agree with Messrs. Smith and Gorman that exogenous variables will impair the Company's ability to quantify savings in future periods?

A: No. *Mr. Smith's concerns with the ability to incorporate differing variables over* the duration of the Savings Sharing Proposal period are unfounded. It is not necessary to speculate, today, at the infinite number of possible internal changes Citizens might go through over the 40-year period, because IAWC is basing its proposal on the set of circumstances in effect today. Future changes in the operating environment will be addressed as they arise at the proposed rate case reviews, and for a water utility, are not likely to be significant, given the nature of ongoing cost activity, i.e. heavily service oriented. Further, the majority of Savings arise because of duplication and scale economies, not gains in productivity which could be achieved absent the Acquisition. In any event, the Savings Sharing Proposal has incorporated opportunities to review such changes in the rate case evaluation process.

Q: Is a 40-year period is too long for savings verification?

A: No. The witnesses' concerns regarding the quantification of savings in periods subsequent to the savings event are unfounded. The savings resulting from a savings event are readily discernible in future years. Once a savings event occurs, it can be periodically reviewed (at rate proceedings) to determine the change or effect, if any, of any exogenous factors. This supposed problem of a 40-year period referenced by Staff does not exist and is nothing more than another "red herring". As other Company witnesses have discussed, Commissions frequently deal with events of a long term nature.

Q: How can the Savings Sharing Proposal provide sufficient proof of savings?

A. Under the proposed Savings Sharing Proposal, Savings will be identified as specific events which can then be quantified, verified and reviewed periodically. Further, comparisons can be made to an agreed upon baseline cost structure prior to the transaction, which can also be verified. As the plan progresses into future periods, these savings events can be reviewed, as they occur in any period, and previous events revisited to ensure that they are still valid and generating verifiable savings for the ratepayers. Detailed records related to changes in cost levels and the effect, if any, of exogenous factors on cost savings will be maintained.

Use of savings sharing plans and forecasts are not anomalous in the ratemaking environment. Many regulatory bodies have approved and operate under them without undue effort. One example of such a plan is contained in the Rhode Island decision regarding the New England Electric System (NEES)– EUA acquisition, where the plan provided for the adoption of a savings sharing proposal, the development of a long-term forecast, subsequent verification of the "enduring nature" of the savings and actual forecast comparison of savings and costs. The IAWC proposal is even more simple and straightforward and contains many of the same safeguards as the NEES-EUA plan that allows for the verification and quantification of cost savings. The use of event-based tracking ensures the ability to identify, quantify and document savings in future periods.

Q: **Do the procedures in the Savings Sharing Proposal provide an "audit trail" *for the Commission to use in future proceedings?***

A: As stated above, the use of event-based savings tracking provides verifiable evidence of cost reduction. These events, as documented, will contain all the elements necessary to create an "audit trail", as described by Mr. Smith. For instance, in the case of the terminated employee position, documents will exist evidencing the reason for termination, the cost of the employee, and the function of the employee; all of which are verifiable. With respect to cost levels absent the Acquisition the baseline, future cost and escalation calculations will be available for verification and review at each of the future ratemaking hearings. Any company-generated assumptions can be tested for reasonableness by the Commission through a paper trail beginning with the first savings event.

Q: Ms. Everson states that, since savings continue into perpetuity, they cannot be verified in the way the Company has indicated. Would you respond to this point?

A: When Savings are identified along with the function, supply, or process related to such Savings, verification of the absence of that expense in future periods is a simple matter of documentation review. For example, if the role of human resources manager is eliminated and replaced with an allocated cost per employee from the corporate parent, the net difference between the allocation and the cost of a human resources manager becomes a savings. To the extent a human resources manager is not subsequently hired, and the corporate parent continues to perform that function, then the total savings remains valid. The Savings would, however, escalate as the salary of a human resources manager changes over time.

Q: Do you agree with Mr. Gorman that the tracking of Demonstrated Savings is prone to error and approximation?

A: No. Mr. Gorman's suggestion is unfounded. The Company has proposed a plan which utilizes several tools to eliminate error and guess work from the Savings identification and tracking process. The Savings identification process will capture savings events in sufficient detail to provide validation that the Savings are real and result solely from the Acquisition. The documentation related to the savings event also enables the ICC to determine that the eliminated cost can be checked in future periods for continued validity. Using a reduced position as an example, the position is terminated, an explanation of why the position was eliminated will be provided, as well as any pertinent cost information. These details set the standards by which these savings will be evaluated in future periods.

Q: Does this conclude your Surrebuttal Testimony?

A: Yes.